Internal Revenue Service

memorandum

CC:TL-N-7116-90
Br4:RBWeinstock

date: JUL 3 1 1990

to: District Counsel, Washington MA:WAS

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This is in response to your recent request for tax litigation advice in the above-captioned case.

ISSUE

1. Whether in computing debt financed income under I.R.C. § 514, an exempt organization may include in its adjusted basis, the basis of real estate held by its wholly-owned I.R.C. § 501(c)(2) subsidiary corporation.

2. Whether petitioner's method of allocating certain expenses between its unrelated business and exempt activities was reasonable.

CONCLUSION

1. An exempt organization may include the basis of real estate held by its wholly-owned I.R.C. § 501(c)(2) title holding company subsidiary in computing its debt-financed income.

2. Based on the administrative record, we cannot make a determination of the reasonableness of the allocation method.

DISCUSSION

The taxpayer in this suit, [redacted] ([redacted]) is the provider of [redacted] benefits in the [redacted] area which purchased an office building (excluding the underlying land) which it partly financed. The office building was used to house petitioner's operations; however during the year at issue, taxpayer rented out office space and parking space to unrelated parties. Because of the mortgage on the building, amounts derived from

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such rental arrangements were debt financed income and not rents excludible from the computation of unrelated business taxable income. The underlying land is owned by a separate subsidiary title holding corporation that [redacted] created for the sole purpose of holding title to the property. The subsidiary is recognized as exempt under I.R.C. § 501(c)(2).

In computing the amount of its unrelated debt financed income on its original Form 990-T for the year [redacted], [redacted] only used the basis of the building, and not the underlying land owned by its subsidiary title holding company. An attachment stated that the subsidiary would be included in a consolidated return with taxpayer. Subsequently, an amended return was submitted in which the value of the underlying land was added to the adjusted basis of the property. Since the underlying land was not debt-financed, the average adjusted basis of the debt-financed property was increased and the "debt-financed" percentage was decreased, as was the taxable income.

As a result of the amended return, the Baltimore Key District conducted an examination of [redacted] and rejected the inclusion of the land held by the subsidiary in computing debt-financed income. The Key District also disagreed with the method used to allocate certain expenses between unrelated business income and exempt income. [redacted] allocated expenses based on the ratio of rent charged to tenants and the rate they state they would have charged themselves. This method, which [redacted] alleges is based on "government contracting principles", resulted in an allocation of approximately 25% of expenses. The Key District reallocated expenses based on more objective standards and arrived at a 20% allocation figure.

1. Consolidation of basis.

[redacted] makes two arguments to support the combining of basis for computing debt-financed income. First, it asserts that it and its subsidiary may use a consolidated return and consolidate assets for purposes of computing unrelated business taxable income. While generally an exempt organization is not allowed to participate in the filing of a consolidated tax return, I.R.C. §1504(e) provides an exception permitting an exempt organization to file a consolidated return with an I.R.C. § 501(c)(2) title holding company when the exempt organization derives income from such corporation. Treas. Reg. §1.1502-100(c) provides that the consolidated unrelated business taxable income for a consolidated return shall be determined by taking into account the separate unrelated business taxable income of each member of the exempt group. We agree with your conclusion that neither Section 1504(e) nor Treas. Reg. § 1.1502-100(c) support the joining of assets together for purposes of computing unrelated business taxable income. Noting this silence, the Exempt Organizations Technical Division stated, "[I]f the assets of the members of the exempt group were to be consolidated, the regulation should have specifically so provided." See the enclosed July 27, 1990 memorandum from the Director, Exempt Organizations Technical Division.

[redacted]'s other argument is that under the rationale of the Supreme Court's opinion in Commissioner v. Bollinger, 108 S.Ct. 1173 (1988), [redacted] is the true owner of the land, and its subsidiary is simply the "corporate agent." In Bollinger, the Supreme Court noted that while the law attributes tax consequences held by a genuine agent to the principal, it was reasonable for the Commissioner to demand unequivocal evidence of the genuineness of an agency relationship. The Court further stated that such genuineness was assured where there was a written agreement when the asset was acquired, the corporation functions as an agent with respect to the asset for all purposes and the corporation is held out as the agent and not the principal in all dealings with third parties.

Your office suggests that the Supreme Court in Bollinger emphasized the genuineness of the agency relationship as opposed to whether the three characteristics discussed have been specified or exist in a particular case. We note that in this case, there was no written agreement. Nonetheless, we share your view as to the genuineness of the agency relationship. [redacted] provided all funds for the purchase of the land held by the subsidiary, and paid related expenses; the subsidiary's name informs other parties that it is a nominee for [redacted]; as a Section 501(c)(2) title-holding corporation, the subsidiary's sole purpose is the hold title for [redacted]; and the subsidiary is completely controlled by [redacted]. We agree with your office's view that the subsidiary is a "genuine corporate nominee" of [redacted].

This reasoning is also supported by Rev. Rul. 77-72, 1977-1 C.B. 157, which holds that the "interorganizational indebtedness" owed to a section 501(c)(5) labor organization by an Section 501(c)(2) title-holding company is not acquisitional indebtedness under Section 514(c). The revenue ruling states that the nature of the title-holding company as well as the parent subsidiary relationship show that the indebtedness is merely a matter of accounting between the two organizations rather than an indebtedness contemplated by Section 514. In the instant case, [redacted] appears to be the true owner of the underlying land and can use the basis of the land in computing its unrelated debt financed income. This view is concurred in by the Exempt Organizations Technical Division.

2. Allocation

Your office did not raise the allocation issue in your advice for technical assistance. Nonetheless, this was an issue raised by the examination, and apparently the basis for the actual deficiency asserted by the Key District.[1] We requested the views of the Exempt Organizations Technical Division as to whether the taxpayer's method was a reasonable method to allocate certain expenses between exempt and unrelated activities.

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[1] The tax computed on Petitioner's amended return results in a refund.

Treas. Reg. § 1.512(a)-1(c) permits an allocation of expenses attributable to facilities and personnel used in both exempt and unrelated business activities to be made on a reasonable basis. Any reasonable method will be satisfactory. Rensselaer Polytechnic Institute v. Commissioner, 732 F.2d 1058 (2d. Cir. 1984), aff'g 79 T.C. 967 (1983). Despite the submissions and workpapers in the file, it is not entirely clear what the precise nature of [redacted] allocation method is. We know it is complex, and required by the federal government for other purposes. However, there is little information as the details and elements of this method. Because of this lack of information, the Exempt Organizations Technical Division was unable to comment as to whether the Key District was correct in concluding the method was unreasonable. They noted that the taxpayer's allocation method produced a figure (25%) that came within 5 percent of the district's allocation figure, and commented that where the allocation percentages seem relatively close, it may be difficult to conclude that the allocation method is not reasonable.

While it may be true that [redacted] allocation percentage was 5% greater than the Service's figure, [redacted] allocation percentage permits a 25 percent greater expense deduction than the method suggested by the Key District. Nonetheless, whether [redacted] allocation method is reasonable is a factual question. One hurdle we face is the fact that the allocation method [redacted] utilized was required by the federal government for other purposes. This does not mean that such method is necessarily a reasonable method for the computation of taxable income. Further factual development of this aspect of the case may be warranted.

We are also returning the administrative file that you provided us. If you have any questions or require any further assistance, please contact Ronald Weinstock at 566-3345.

MARLENE GROSS
Assistant Chief Counsel
(Tax Litigation)

By: _____
HENRY G. SALAMY
Chief, Branch No. 4
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Enclosure:
As stated